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REAL ESTATE

Vol. 2, No. 4 April 1989

OUTLOOK

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The U.S. Department of Commerce recently announced its second revision to fourth quarter real GNP growth, reporting an annual rate of growth of 2.4 percent. Economic growth in the non-farm sector during the fourth quarter was quite strong, advancing at an annual rate of 3.5 percent.
- Indicators of the strength of non-farm growth so far in 1989 have been pretty mixed: signs of an economic boom (and accelerating inflation) in the January statistics were quickly countered by February declines in retail sales, factory operating rates, durable goods orders, housing starts, home sales, and the index of leading indicators. The coming months will show whether economic activity in February was a reaction to tighter credit or the beginning of a slowdown in the rate of growth.
- Recent advances in short-term U.S. interest rates have once again increased demand for U.S. dollars, leading to a rise in the dollar's value and further complicating efforts to curb the trade deficit.
- Housing starts slowed 11.4 percent in February to an annual rate of 1.498 million units, from the 1.69 million unit pace of January. The decline was caused by colder, more seasonable weather, and the February leap in interest rates.
- Sales of new single-family homes fell to an annual rate of 626 thousand units in February, 9.4 percent below the revised January sales rate of 691 thousand units (originally reported as 704 thousand units), and 4.6 percent below the 656 thousand unit rate of a year ago.
- Existing single-family home sales slipped 3.1 percent in February to an annual rate of 3.44 million units. While the February sales figures were the slowest since the beginning of the last homebuying season in March 1988, they were still 3.6 percent ahead of the February 1988 sales pace.
- The price of an existing single family home rose 3.8 percent in February to a new high of $93,100. This price is 4.7 percent above the $88,900 median price of one year ago. Meanwhile, the median price of a new single-family home rose 8.9 percent to $123,000, from $113,000 in January.

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LIES, DAMNED LIES AND STATISTICS

Economic Commentary

by
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One of the major arithmetic breakthroughs of this past year has been the statistical explosion that has occurred during the recent college basketball season. Suddenly, we read in the papers that good ol' State U. is 19-1 when its opponents shoot less than 44 percent during the last two minutes of each half. Or Seth Thomas University (affectionately known in some cities as Tick Tock Tech) is 27-6 when leading by more than 6.38 points at halftime. I've been waiting for the ultimate statistical insight: Wassamatta U. is undefeated when it scores more points than the other team. This of course is merely a paraphrase of Calvin Coolidge's dazzling dictum, "When more and more people are thrown out of work, unemployment results."

These thoughts may seem unduly cynical from one who derives at least part of his living being responsible for the exposition of numbers about both the housing sector and the economy. Think of it as quality control. Just as the average REALTOR® does not want the profession seen as less professional than it really is, so too, we who deal with numbers don't want to see the public led down the garden path by the creator of the sexy, but ultimately meaningless number. And that seems to be happening a great deal lately.

We know that the Federal Reserve is actively battling inflation by slowing the economy through higher interest rates. But the welter of statistics we see in the daily papers and on business news programs seem to be pointing in very different, if not opposite directions. Does one believe that inflation is rampant, because the February Producer Price Index is up a full percentage point (more than expected), or should we be reassured that the Fed has been successful, because the Consumer Price Index for February is up only 0.4 percent (less than expected)? It would be nice to answer "damned if I know!", but the fact is we need to know the real answer.

With all of the numbers that are thrown at us--some because they are important; others because it will get their issuer publicity--it's time for a kind of Reader's Guide to Economic Data. So, here's our effort:

1. **Numbers don't matter; what they represent does.** Inflation, for example, is a problem only if the core rate of inflation for the economy is rising. In February, the Producer Price Index rose dramatically because of food and energy price jumps. Now if the OPEC nations can hold together and continue to push up the price of oil and/or the drought of 1988 becomes the drought of 1989, then the increases we saw do indicate a rise in the core rate of inflation. If not, then these are short-term increases, and inflation will not be a continuing problem. As with any economic question, look behind the number, and see the meaning.

2. **Weekly numbers are not worth printing; monthly numbers may be little better.** The only weekly number that should have any validity in your lives is the number on your pay stub. In the world of economics, weekly numbers are the product of random static, and events take shape only over much longer periods. Most statistics watchers have discovered this through painful experience with weekly money supply numbers, although the emphasis placed on the monthly trade numbers suggest that they didn't learn much. Granted, those of you who are active traders should rely on the short term numbers; but anyone who uses the *Wall Street Journal's* "Credit Markets" column to forecast interest rates is simply not seeing the forest.

3. **Some popular numbers simply don't matter.** The Dow Jones Industrial Average, like the national political conventions and the Academy Award presentations, is essentially a private party that has no business being thrust on the consciousness of the average American. We found out after the Crash how little that number either says about, or influences, economic life. Not every economic or financial fact that reaches the public media deserves your attention.

4. **Figures don't lie; but liars figure.** Statistics are meaningful only in context, and without the context they take on the flavor of "Three out of four doctors recommended asparagus souffle for a fever." These guys, of course, could be Dr. Seuss, Dr. J. and Doctor Doolittle, and without that backup, you really can't be sure of the real meaning of the numbers. Most statistics are best seen within their historical sweep. It's often more important to know whether a figure is high by seasonal or historical standards rather than that it is simply high.

So, where does this leave us. Essentially, any worthy commentator ought to give you information that follows the rules listed above. The role of the professional economist, like the role of the REALTOR®, is to organize and analyze information to the best advantage of his audience. Any less is a real abdication of responsibility. With this in mind, be selective of your sources, read deeply and seek meaning rather than simply a number. And remember--as much as we would like it, not every one is above average.

Outlook for the Economy and Real Estate

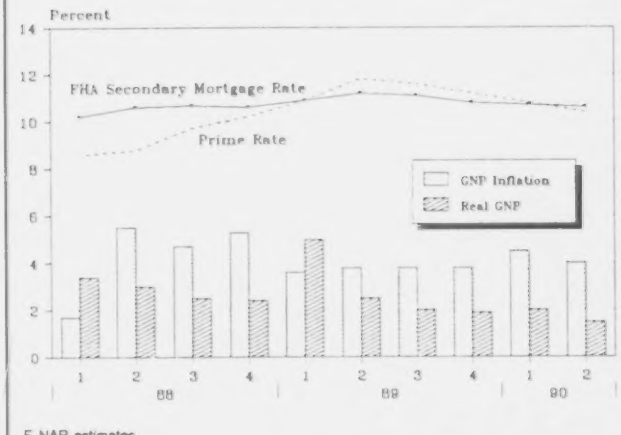
ECONOMIC OUTLOOK

The U.S. Department of Commerce recently announced its second revision to fourth quarter real GNP growth, reporting an annual rate of growth of 2.4 percent. Economic growth in the non-farm sector during the fourth quarter was quite strong, advancing at an annual rate of 3.5 percent. The GNP statistics will continue to be clouded by effects of the drought of 1988 at least through the first quarter of this year. In preparing their estimate of first quarter 1989 real GNP growth, Commerce Department economists will add a full 2.5 percentage points to their figures in order to account for an expected resurgence of farm production to a more normal level. This is not to say that they expect a very early harvest this year, say, sometime late last month. Rather, the Commerce Department estimates annual farm production early in the year and distributes this amount fairly evenly among the four quarters. Therefore, the greatest quarterly change in farm production will come in the first quarter GNP estimate. However, most of the attention focused on that release (on April 26) will be on the non-farm component of GNP growth.

To date, indicators of the strength of non-farm growth so far in 1989 have been pretty mixed: signs of an economic boom (and accelerating inflation) in the January statistics were quickly countered by February declines in retail sales, factory operating rates, durable goods orders, housing starts, home sales, and the index of leading indicators. For example, new orders for manufactured durable goods slowed by 3.6 percent in February, marking the first back to back drop in three years (orders fell 2.9 percent in January). Orders for non-defense capital goods, a good gauge of business investment, fell 8.9 percent. A slower pace of durable goods orders is important because it could ease the mounting pressure on operating rates at factories that has raised costs and threatened to increase wage demands. Uncertain indicators notwithstanding, the Fed is focused on containing the inflation beast in a cage of tight money and high short-term interest rates. The coming months will show whether economic activity in February was a reaction to this tighter credit policy or the beginning of a slowdown in the rate of growth. We suspect it was a little of both, and we expect that real GNP growth will slow moderately in 1989 to 3.0 percent, from 3.8 percent in 1988.

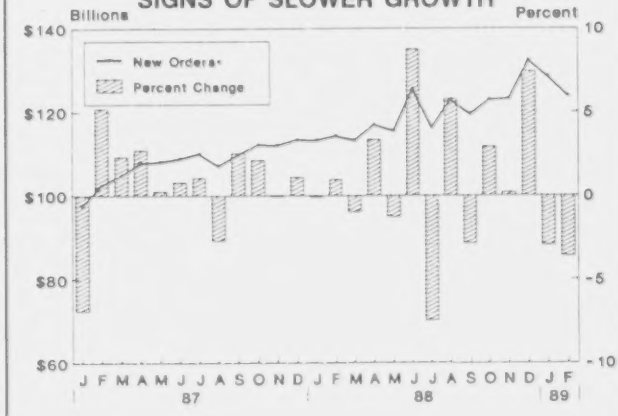
The Fed remains very concerned about the prospects for accelerating inflation for what seem to be two reasons. First, the Fed's recent actions stem partly from big increases in domestic price indexes: for example, the Producer Price Index jumped 1.0 percent in January and February. However, other inflation barometers, like the Survey of Purchasing Managers and the Consumer Price Index (CPI) are less conclusive. In the latest Purchasing Manager survey, only 38 percent reported higher prices during February, the smallest share since March 1987. Also, after jumping 0.6 percent in January, the CPI rose a modest 0.4 percent in February. Graph 3 shows that the tendency for producer prices to feed into consumer prices has been muted recently. The second reason for the Fed's concern is not so much the rate of economic growth, but rather the level of national output. That is, many industries seem to be operating at or near their capacity, with employment at very high levels, and this has contributed to a build up of inflationary pressures.

GRAPH 1: THE ECONOMIC OUTLOOK



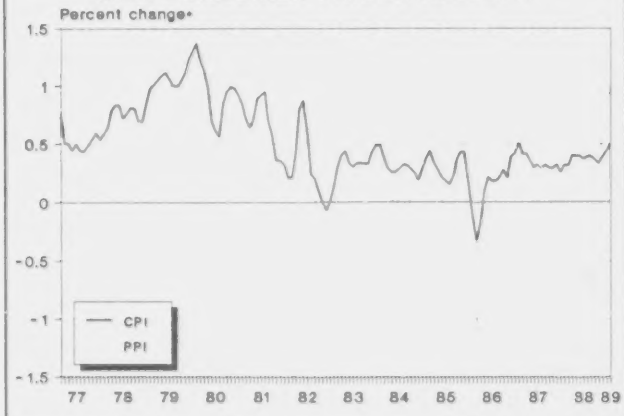
E NAR estimates

GRAPH 2: THE ECONOMY SHOWS SIGNS OF SLOWER GROWTH



Source: Bureau of Labor Statistics *For Manufactured Durable Goods

GRAPH 3: PRODUCER PRICES ARE UP.. WILL CONSUMER PRICES FOLLOW?



Source: Bureau of Labor Statistics *Three month moving average

In addition to the domestic inflation barometers, the U.S. merchandise trade deficit has to be watched for its potential effects on the rate of inflation and the course of monetary policy. Recent advances in short-term U.S. interest rates have once again increased demand for U.S. dollars, which has in turn led to a rise in the dollar's value. On the surface, a stronger dollar sounds good (anything American that's stronger has got to be better), and if the change were to stick, it would help American consumers buy more imports. However, a stronger dollar is actually more a hindrance than a help in the ongoing process of eliminating the U.S. trade deficit. A stronger dollar complicates efforts to curb the trade deficit by expanding exports and slowing imports. In fact, after falling by 27.7 percent in the first three quarters of 1988, the trade deficit grew 9.3 percent in the fourth. Further, considerable improvement is not likely in the second quarter of 1989, without a substantial fall in the dollar. Recently, the G-7 nations seem to have set a cap on the value of the dollar at 1.9 marks and 140 yen, leading to speculation that the Fed will come under pressure to intervene in international currency markets if the dollar approaches these levels. To intervene, the Fed sells dollars to lower its value, but this in turn increases the U.S. money supply thereby offsetting the Fed's own efforts to restrict credit here at home.

Monetary Policy and Interest Rates

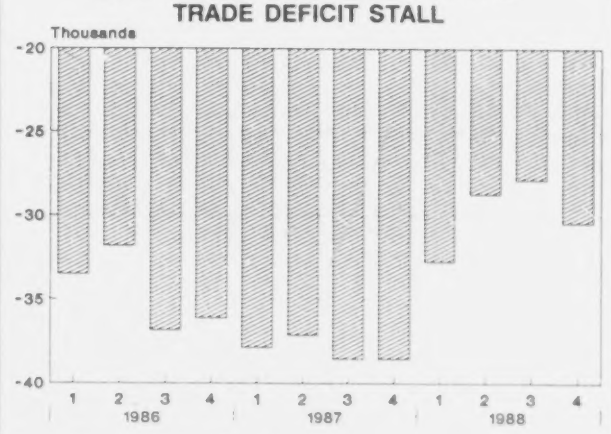
Regarding the Fed's efforts on the domestic front, the monetary authority presently appears to be evaluating the effectiveness of its earlier credit tightening. With most indicators pointing towards an easing of economic growth, it would seem unlikely for the Fed to move very aggressively on short-term rates unless new indications of a stronger economy emerge. The Fed hopes that the next few months will show that its anti-inflationary tactics have paid off, leading to a gradual slowing of the economy. Still, many analysts argue that all of the interest rate hikes of the past several months may not be enough to slow the economy's momentum and forestall the onset of high rates of inflation. We do not concur. Rather, we believe that a few more adjustments in short-term interest rates may be necessary to slow the economy, but that interest rates will trend down beginning in the second half of this year. In sum, the often competing demands of price stability at home and international confidence in the dollar will continue to challenge the Fed in the months ahead, and maintain some upside risks to the interest rate forecast.

REAL ESTATE MARKETS

Housing Starts

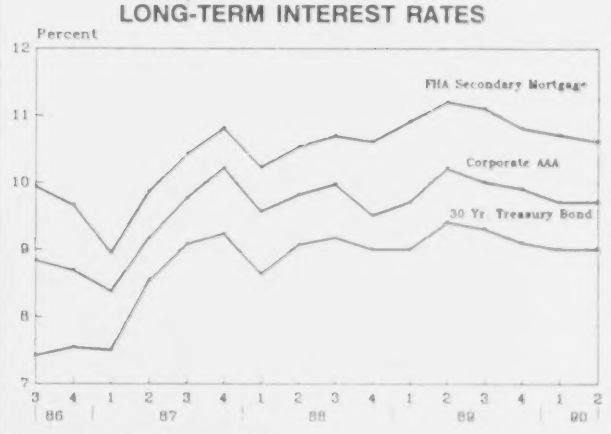
Housing starts slowed 11.4 percent in February to an annual rate of 1.498 million units, from the 1.69 million unit pace of January. The decline was caused by colder, more seasonable weather, and the February leap in interest rates. Single-family starts, after reaching a 16 month high in January at an annual rate of 1.202 million units, fell 13.1 percent to 1.045 million units, putting single-family starts 4.6 percent below the 1.095 million unit rate of a year ago and marking the largest monthly decline since March 1984. Starts of multi-family structures with 2-4 units dropped 6.0 percent to an annual rate of 63,000 units, but remained 8.6 percent above the 58,000 unit rate of a year ago. Starts of buildings with 5 or more units slowed by 7.4 percent to a seasonally adjusted annual rate of 390 thousand units, 8.9 percent more than the 358 thousand unit rate of February 1988.

GRAPH 4: IMPROVEMENTS IN THE TRADE DEFICIT STALL



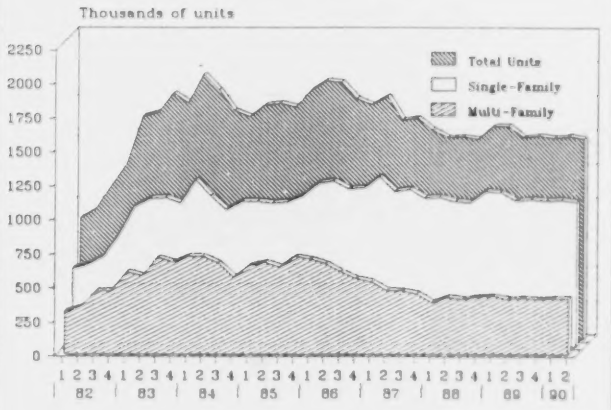
Source: The Federal Reserve Board

GRAPH 5: THE FORECAST FOR LONG-TERM INTEREST RATES



Source: The Federal Reserve Board

GRAPH 6: HOUSING STARTS



Source: The Bureau of Census, E NAR estimates

New Home Sales

Sales of new single-family homes fell to an annual rate of 626 thousand units in February, 9.4 percent below the revised January sales rate of 691 thousand units (originally reported as 704 thousand units), and 4.6 percent below the 656 thousand unit rate of a year ago. The February rate was the lowest in thirteen months, with the overwhelming majority of the drop occurring in the Northeast and in the South. In the Northeast, after rising to a rate of 126 thousand units in January from a low of 65 thousand units during November (a two month increase of 94 percent), sales fell 19.8 percent to a seasonally adjusted annual rate of 101 thousand units. Sales dropped 14.4 percent in the South to an annual rate of 214 thousand units, the slowest rate since January of last year. Midwest sales reached an annual rate of 101 thousand units in February, off 1.0 percent from the January rate of 102 thousand units. In the West, sales slipped 1.4 percent to a seasonally adjusted annual rate of 210 thousand units in February from the January revised rate of 213 thousand units. Relative to February 1988, new home sales were down in the Northeast, Midwest, and the South (by 9.8 percent, 10.6 percent, and 19.6 percent, respectively) but rose 27.3 percent in the West.

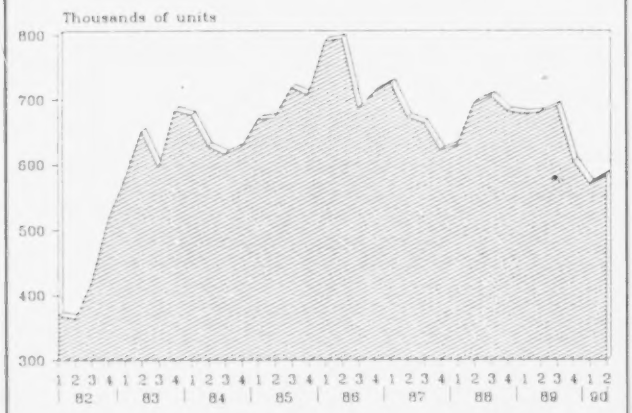
Existing Home Sales

When preliminary estimates of the December 1988 existing single-family home sales rate shot past 4 million units, few analysts expected the housing market to retain that kind of momentum in a time of rising interest rates. The first two months of 1989 have proven this to be true, with sales dropping consecutively for the first time in over a year. Despite the decline, existing single-family homes were sold at the robust annual rate of 3.44 million units in February. This pace was down only 3.1 percent from the January annual rate of 3.55 million units. While the February sales figures were the slowest since the beginning of the last homebuying season in March 1988, they were still 3.6 percent ahead of the February 1988 sales pace. Existing single-family home sales are expected to fluctuate around the 3.4 million to 3.5 million unit range through the 1989 homebuying season. Later in 1989, as economic growth cools down, existing single-family home sales are expected to slow in the fourth quarter to an annual rate of about 3.3 million units.

Home Prices

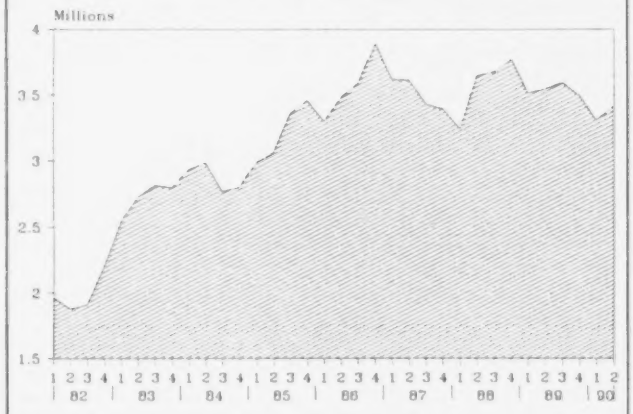
The price of an existing single family home rose 3.8 percent in February to a new high of $93,100. This price is 4.7 percent above the $88,900 median price of one year ago. The large monthly price increase, despite slower sales, could be an early sign that higher interest rates are squeezing out homebuyers in the lower-priced end of the market. A similar situation has been observed from time to time in the market for new homes, where the median price of a new single-family home in February rose 8.9 percent to $123,000, from $113,000 in January. In 1989, both existing and new single-family home prices are expected to continue their excellent record of keeping pace with inflation. The median price for an existing single-family home is expected to increase 5.4 percent in 1989 to $94,100. The median price for a new single-family home is expected to increase 4.9 percent to $118,000 over the course of 1989.

GRAPH 7: NEW HOME SALES



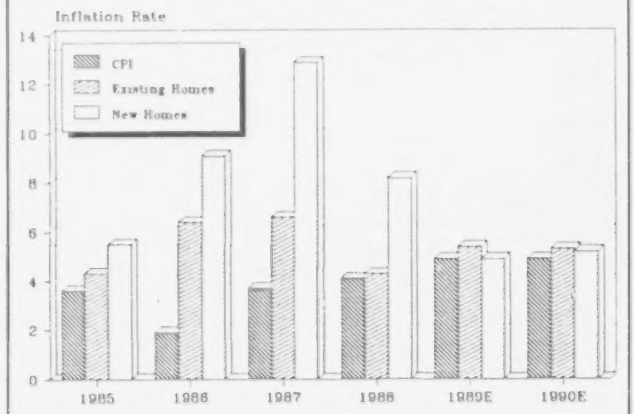
Source: The Bureau of Census; E NAR Estimates

GRAPH 8: EXISTING SINGLE-FAMILY HOME SALES



Source: NAR Economics and Research; E NAR Estimates

GRAPH 9: HOME PRICES



Source: NAR; E NAR Estimates

REGIONAL DATA

Housing Starts

The return of more seasonal weather in February had its greatest effect on housing construction in the Northeast, where starts fell by 22.6 percent to a seasonally adjusted annual rate of 229 thousand units. The drop followed a 47.3 percent increase in January, and left starts 23.7 percent slower than February 1988. Notably, February 1989 marked the 11th consecutive month that housing starts in the Northeast have been slower than the previous year. In the Midwest, housing starts were down 13.7 percent to a seasonally adjusted annual rate of 277 thousand units, but 8.2 percent faster than a year ago. Privately owned homes were started at an annual rate of 400 thousand units in the West, 8.7 percent below the January rate but 10.8 percent faster than the year before. In the South, starts dropped 6.8 percent to a seasonally adjusted annual rate of 592 thousand units, virtually unchanged from the 594 thousand unit rate set in February 1988.

Existing Home Sales

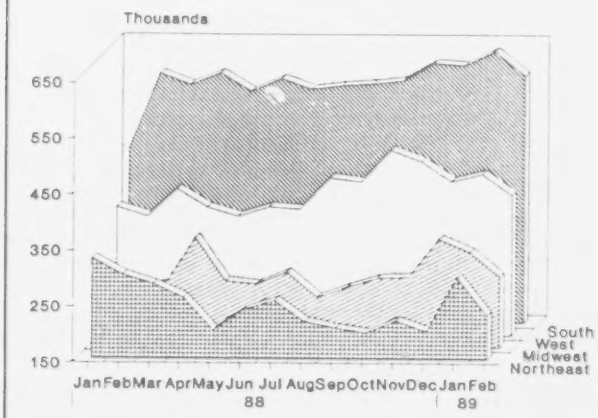
Sales in the Northeast, which managed to remain strong in January despite slowing sales rates throughout the rest of the country, plunged 18.3 percent in February to a seasonally adjusted annual rate of 580 thousand units, 12.1 percent slower than the February 1988 annual rate of 660 thousand units. Sales in the Midwest were off 1.1 percent to a 920 thousand unit pace, but 4.5 percent faster than the February 1988 annual pace of 880 thousand units. February sales in the South reached 1.3 million units, virtually unchanged from the 1.31 million unit rate of January, but up 5.7 percent from the 1.23 million unit pace of February 1988. The West was the only region to post a gain in the rate of existing home sales, where sales rose 3.2 percent in February to a seasonally adjusted annual rate of 650 thousand units, putting the sales rate in the West 20.4 percent above that of a year ago when homes were sold at an annual rate of 540 thousand units.

Home Prices

The median sales price of an existing single-family home located in the South jumped 7.4 percent to $88,500 in February, after rising 5.4 percent in January, in what now appears to be a trend of firming prices in that region. The consecutive monthly rise put home prices in the South at an all time high, and 4.6 percent above the $84,500 median price of a year ago. Prices in the West were up 2.3 percent for the month, and 12.4 percent for the year ending in February at $133,700. In the Midwest, at $69,900, prices were up 3.1 percent from January and 3.9 percent from the year before. Home prices in the Northeast were virtually unchanged at $142,600 (a drop of 0.8 percent), but 3.2 percent higher than one year ago.

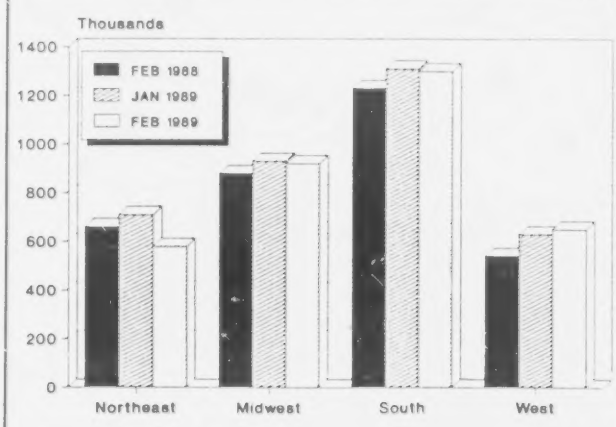
Sean A. Burns
Director of Forecasting
Beth M. Maerz
Research Associate

GRAPH 10: HOUSING STARTS BY REGION



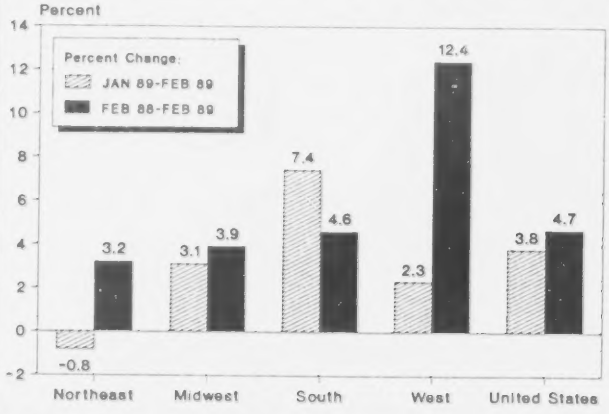
Source: Bureau of Census

GRAPH 11: EXISTING HOME SALES BY REGION



Source: Bureau of Census

GRAPH 12: HOME PRICES BY REGION



Source: NAR Economics and Research

REAL ESTATE AND IMPACTS OF THE CAPITAL GAINS PROPOSAL

The President's Capital Gains Proposal has produced much sensation in the recent weeks since its unveiling. The concepts have been attacked on several fronts: first, the proposal is criticized as giving most of the tax breaks to the very wealthy; second, analysts have widely varying estimates of its revenue impacts, and finally, because certain types of assets and property have been excluded. This article analyzes these issues as they relate to real estate. It is found that while the current proposal is extremely biased in favor of the wealthy, including real estate would reduce the regressivity of the proposal. The controversy over the revenue effects of a capital gains rate reduction is a longstanding one which is yet to be resolved. Moreover, the current proposal would tend to bias investments away from real estate towards financial assets.

DISTRIBUTIONAL ANALYSIS OF CAPITAL GAINS PROPOSAL[1]

Regressive Nature of the Current Capital Gains Proposal:

It is understandable why this capital gains proposal has caused such an uproar. The tables below indicate the extent of the bias in favor of the wealthy. The data presented below are for 1985 from the Federal Reserve Board 1986 Survey of Consumer Finances.[2] Table 1 displays household assets by 3 income classes while Table 2 shows the percent of total assets held by each income class. Table 2 indicates some revealing facts about the regressivity of the proposal:

- The wealthiest 1 percent of the population (those with over $150,000 in income) make 12 percent of total income, and hold a disproportionate amount of total wealth in the form of financial assets. This group holds 45 percent of the bonds and 43 percent of stocks (in $'s), while making 12 percent of total income. Thus, the wealthy hold a disproportionate amount of capital gains producing assets eligible for tax relief under the proposal.

- Households with income between $30,000 and $150,000 make up 33 percent of the population , receive 57 percent of the total income, and hold 38 percent of the bonds and 43 percent of the stocks. Thus, these households own a smaller proportion of stocks, relative to income, than the higher income group.

- Households making incomes less than $30,000 account for 66 percent of the total households, but receive only 31 percent of total income. They hold a disproportionately low amount of financial assets which would benefit from the capital gains proposal. This group holds only 17 percent of total bonds and 14 percent of stocks. Thus, lower income households would not receive very much benefit from the proposal. Their financial assets consist mostly of savings accounts, CD's and IRA's. The President's proposal does include special provisions for lower income households, but these breaks are not terribly meaningful if these taxpayers hold only minimal amounts of stocks.

Table 1
SELECTED HOUSEHOLD ASSETS BY INCOME CLASS
($ MILLIONS)

1985 Total Income From:	To:	Number of Households (000s)	Total Income	Market Value of Home	Market Value of Non-home Real Estate	Bonds	Stocks	Value of Real Estate, Stocks and Bonds
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
0	30,000	56,002	790,329	1,759,074	706,834	73,780	174,787	3,504,804
30,000	150,000	28,044	1,435,583	2,410,116	1,152,203	162,768	531,680	5,692,350
150,000	and over	825	306,456	265,012	354,078	192,978	539,178	1,657,702
Total		84,871	2,532,368	4,434,202	2,213,115	429,526	1,245,645	10,854,856

Source: 1986 Survey of Consumer Finances, Federal Reserve
Condensed version of tabulations by Price-Waterhouse

Table 2
SELECTED HOUSEHOLD ASSETS BY INCOME CLASS
Percent of total, by income class

1985 Total Income From:	To:	Number of Households (000s)	Total Income	Market Value of Home	Market Value of Non-home Real Estate	Bonds	Stocks	Value of Real Estate, Stocks and Bonds
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
0	30,000	65.98%	31.21%	39.67%	31.94%	17.18%	14.03%	32.29%
30,000	150,000	33.04%	56.69%	54.35%	52.06%	37.89%	42.68%	52.94%
150,000	and over	0.97%	12.10%	5.98%	16.00%	44.93%	43.29%	15.27%
Total		100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Households hold Non-Owner-Occupied Real Estate in proportion to their income:

The proposal excludes certain types of investment real estate from preferential treatment. Under current law, owner-occupied residences are generally protected from capital gains taxation and would be relatively unaffected by the changes. Table 2 (col. 4) indicates that households tend to hold non-home[3] real estate roughly in proportion to their income. Note the following facts illustrated by Table 2:

- Households with income less than 30,000 earn 31 percent of total income and hold 32 percent of non-home real estate.

- Households in the $30,000 to $150,000 income class receive 57 percent of the income and hold 52 percent of non-home real estate.

- The wealthiest group of households, those making over $150,000, receive 12 percent of the income and hold 16 percent of the total non-home real estate.

Thus, the reduction in the capital gains tax for non-home real estate would benefit all households in proportionate to their income.

Including Real Estate in the Proposal Would Help Reduce the Regressivity of the Proposal:

Because such a large proportion of the financial assets proposed to receive preferential treatment are held by the wealthiest 1 percent of households, inclusion of real estate in the proposal cannot totally eliminate its regressivity, but it can help alleviate it substantially. The wealthiest 1 percent of households hold 44 percent of the value of stocks and bonds but only 16 percent of the value of non-home real estate and 6 percent of owner-occupied home value. In contrast, the 66 percent of households making $30,000 or less (who account for 32 percent of total income) hold only 15 percent of the value of stocks and bonds, but own 32 percent of non-home real estate and 40 percent of owner occupied homes (value). Thus, including real estate would help reduce the severity of the regressivity. In fact, Table 2 (col. 8) indicates that households hold the combination of stocks, bonds and real estate (including homes) in about the same proportion as their income.

REVENUE EFFECTS OF THE PROPOSAL

There is also considerable concern about the potential revenue effects of the proposal. Joint Committee on Taxation (JCT) Chief of Staff Ronald A. Pearlman revealed at a recent Senate Finance Committee hearing that capital gains realizations would have to double permanently to avoid losing money under the President's proposal. Pearlman further argued that such an assumption defies historical evidence. In support of the proposal, the Treasury projected a $9.3 billion increase in revenue for fiscal years 1989 through 1994. However, the JCT has estimated that it would lose over $23.9 billion over the same period.

The discrepancy in revenue estimates exist because the effect of tax rate changes on capital gains realization rates are controversial. A tax cut would be expected to reduce revenue if the realizations rate remains the same. However, a reduction in tax rates is expected to increase the frequency of realizations. If realizations increase significantly enough, tax revenue could actually increase due to a tax cut. Studies using different data and methodologies have arrived at opposing conclusions on the effect of a tax reduction for capital gains on revenues. A 1985 Office of Tax Analysis study[4] found that although real estate capital gains realizations are not responsive enough to offset a tax cut, the capital gains tax reductions in the 1978 and 1981 acts both raised revenue. However, an earlier study by Auten[5] found that a capital gains tax rate reduction for real estate would be approximately self financing.

EXCLUSION OF REAL ESTATE AND OTHER ASSETS FROM THE PROPOSAL

The current proposal does not include depreciable and depletable assets such as buildings. However, while buildings will not be eligible for preferential capital gains treatment, land will be eligible. Thus, the proposal as structured in this way encourages low density developments, and discourages investment in real estate relative to financial assets. The proposal also excludes collectibles such as gold coins, jewelry, antiques, etc.

The proposal is purported to encourage long term investment, but in fact is geared towards certain kinds of assets which yield large capital gains (which tends to be riskier). But even here it is being criticized as not meeting its goal of generating increased investments since realized losses are not accounted for. Losses can only be recouped if the investor has offsetting capital gains. The proposal also biases the taxpayer into switching from assets which yield high dividends and low capital gains to assets which yield low dividends and high capital gains - for example, from savings accounts to high risk stocks. Thrift executives are very concerned about the impact of this aspect of the proposal on their industry.

Another justification for the proposal is to "roughly correct for the taxation of purely inflationary gains". However, the proposal, if enacted, would introduce an inequity in the system in that only a fraction of the problem would be corrected. The taxation of inflationary gains resulting from the returns to savings accounts would not be corrected, nor would inflationary gains resulting from returns to investment in human capital - such as education.

by
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1.This analysis is based on the assumption that capital gains are proportional to the value of the assets.

2.Although, they are over three years old it is assumed the relative distribution of ownership has not change significantly.

3.The term "non-home real estate" is used synonymously with "non-owner-occupied real estate".

4.Office of the Secretary of the Treasury, Office of Tax Analysis, Report to Congress on the Capital Gains Tax Reductions of 1978 (September 1985).

5.Gerald E. Auten, "Estimation of the Effects of Capital Gains Taxes on the Realizations of Capital Gains," Final Report on a Project for the Office of Tax Analysis, U.S. Department of the Treasury, October 21, 1981

THE ASSETS OF PROSPECTIVE FIRST-TIME HOMEBUYERS: A LOOK AT THE 1983 AND 1986 SURVEYS OF CONSUMER FINANCES

Previous analysis of the 1983 and 1986 Surveys of Consumer Finances[1] has looked at household wealth and savings,[2] as well as the phenomena of increasing consumer installment debt and the changing types of credit preferred by consumers.[3]

But the uses for the 1983 and 1986 databases are plentiful and many largely untapped. With the increasing burden of high home acquisition costs -- downpayments, mortgage insurance, closing costs, etc., -- REALTORS, homebuilders, mortgage lenders and others in the real estate industry need to determine what resources are available to potential first-time homebuyers for overcoming these hurdles. The 1983 and 1986 Surveys of Consumer Finances can give us a glimpse of the asset portfolios, and other characteristics, of potential first-time homebuyers.

I."Potential" vs. "Prospective First-time Homebuyers"

What constitutes a "potential first-time homebuyer?" All renting households which have never owned their homes have commonly been thought of as "potential first-time homebuyers." Although rising in recent years, according to several surveys the median age of the "first-time homebuyer" remains between 25 and 34 years.[4] Therefore, we will confine our definition of "potential first-time homebuyers" to households which rented in both 1983 and 1986 who are within this age group.

In addition, while all renting households (between 25 and 34) which have never owned are potentially first-time homebuyers, the characteristics of some of them will make homeownership unlikely, at least in the forseeable future. For example, some such households will lack the desire for homeownership and some will have very low incomes. Indeed, the median household income of first-time homebuyers is $36,000.[5] Thus, in order to focus on those who are able to soon make the switch to owning, low income renters should be excluded from the analysis. The implication is that sufficient income is a prerequisite to afford the expenses of owning a home. But asset position is also very important, even if income is sufficient.

The first three columns of Table 1 show average incomes and the income distribution for three groups of 25 to 34 year olds.[6] The table illustrates that there is quite an income differential between the "potential first-time homebuyers" and each of the other young household types. The 1985 household income of our "potential first-time homebuyers" was only 65 percent of that of "first-time homeowners" and only 62 percent of that of young "non first-time homeowners". The income shortfall appears to be applicable to 1983 and 1984 as well. In fact, "first-time homeowners" experienced greater growth in average income between 1984 and 1985 than "potential first-time homebuyers" -- 27 vs. 18 percent.

Table 1 also suggests a disproportionately large share of "potential first-time homebuyers" with 1985 incomes below $20,000. While forty-seven percent of "potential first-time homebuyers" earned 1985 household incomes less than $20,000, only 19 percent of "first-time homeowners" had less than $20,000 in 1985 household income. And an even smaller proportion (15%) of young "non first-time homeowners" had income less than $20,000.

Due to the income disparity, we will further constrain our sample of 25 to 34 year old "potential first-time homebuyers" to those with 1985 household incomes of $20,000 or more. This will be our focus group of "*prospective* first-time homebuyers." We will similarly constrain our "first-time homeowners" and one group of "non first-time homeowners." The last group, "non first-time homeowners" of all ages and incomes, is included in the last column of all the tables for comparison, but will not be discussed.

II. Financial and Real Assets of "Prospective First-time Homebuyers"

The Surveys of Consumer Finances provide us with snapshots of their households' assets. Table 2 shows the percentage of households holding each of 11 asset types in 1986. While all "prospective first-time homebuyers" had checkings and/or savings accounts and most had vehicles, only small shares of them held each of the other asset types. Only one-third of the "prospective first-time homebuyers" had profit sharing and thrift accounts and stocks and mutual funds; while one-quarter or less had IRAs and Keoghs, money market accounts and CDs, life insurance with cash value, bonds and the remaining asset types. (The percentage of "prospective first-time homebuyers" holding IRAs -- 25% or roughly 946,000 households within the population of "prospective first-time homebuyers" --is particularly interesting due to to the proposal to allow tax-exempt withdrawals from IRAs if used as a downpayment on a first home.) Similar results apply to the both groups of young homeowners.

Table 3 shows the median asset value for those who hold the asset. No clear pattern emerges on the assets of "prospective first-time homebuyers" vis-a-vis the assets of comparable homeowners. While both groups of homeowners had greater median values for 7 of the 11 asset types, the differences in many cases were not substantial. Moreover, for "prospective first-time homebuyers", the 1986 median value for IRAs and Keoghs was $4,500, and for profit sharing and thrift accounts was $4,000. These were greater than the same values for the comparable homeowners. The median total asset values (exclusive of current home value) are greater for the comparable homeowners -- $18,396 for "first-time homeowners" and $24,364 for "non first-time homeowners" compared to $15,319 for prospective first-time homebuyers.

Another measure of financial security is pension coverage, particularly 401(k) plans. "Prospective first-time homebuyers'" involvement in such plans should be of particular interest to REALTORS®. Like IRAs, this stems from the ongoing proposal to allow first-time homebuyers to withdraw funds from without tax consequences 401(k)s and similar tax-deferred salary reduction plans for downpayments on homes. Only one-fifth of the "prospective first-time homebuyers" -- or approximately 757,000 households within the population of "prospective first-time homebuyers" -- and only seven percent of their spouses are covered by such plans. This suggests that such a proposal aimed at "prospective first-time homebuyers" would miss a good portion of the target households.

III. Reasons for Household Savings

The reasons for saving among many "prospective first-time homebuyers" strongly suggest that the desire for homeownership still exists for many. Table 4 indicates that the largest percentage (32%) of "prospective first-time homebuyers" were saving primarily to buy their own homes; the second largest percentage (20%) were saving primarily for use in emergencies. This parallels evidence from the renting households (who have never owned a home) from the 1986 National Association of REALTORS Homeownership Survey, one-fifth of whom indicated that their primary reason for saving is for a home downpayment. The only reason cited by a larger percentage (24%) of renters from the NAR Survey as their chief incentive for saving was for use in an emergency.

IV. Conclusion

While the prospect for homeownership is strong for some renting households, there are many who lack the means to overcome the formidable homeownership costs in spite of a strong desire to own. (These costs were discussed in the November 1988 *Real Estate Outlook*, "Explaining Trends in Homeownership".) Faced with declining growth in real income and rising rents in many areas, many renting households are unable to save. Those who are able to save often find that their savings aren't enough because rising home prices caused downpayments and other acquisition costs to soar.

Data from the 1983 and 1986 Surveys of Consumer Finances indicate that many renting households do not hold financial and real assets other than checking and savings accounts and vehicles (whose liquidity is questionable), and this should be kept in mind when strategies to promote homeownership are pondered.

by
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1.The surveys were jointly sponsored by the Board of Governors of the Federal Reserve System and several other government agencies. The 1983 and 1986 Surveys are longitudinally-linked so that households interviewed in 1983 were reinterviewed in 1986, if possible. The Surveys contained questions about household demographics, income and expenditures, balance sheet and mortgage information, employment history and health benefit information, etc. For details, see Robert B. Avery and Gregory E. Elliehausen, Board of Governors of the Federal Reserve System, 1983 Survey of Consumer Finances: Technical Manual and Codebook and the corresponding 1986 manual by Avery and Arthur B. Kennickell.

2.See Robert B. Avery and Arthur B. Kennickell, Board of Governors of the Federal Reserve System, Savings and Wealth: Evidence from the 1986 Survey of Consumer Finances, prepared for a conference on research in income and wealth, NBER, May 1988.

3.See Robert B. Avery, Gregory E. Elliehausen and Arthur B. Kennickell, "Changes in Consumer Installment Debt: Evidence from the 1983 and 1986 Surveys of Consumer Finances," Federal Reserve Bulletin, October 1987.

4.For a comprehensive discussion of the characteristics of first-time homebuyers, see John Simonson, Prospective First-time Homebuyers: Salient Characteristics and Their Implications, report prepared for the National Association of REALTORS, February 1989.

5.Information on first-time homebuyers and financing methods from the NAR Spring 1988 Residential Mortgage Finance Survey.

6.Since there is no way in which to discern household tenure either before 1983 or between 1983 and 1986, we will make some assumptions. First, it is highly probable that households between 25 and 34 which rented in both 1983 and 1986 have never owned. Therefore, we will assume such and consider this group "potential first-time homebuyers." Second, it is plausible that households which rented in 1983 and owned in 1986 between 25 and 34 are "first-time homeowners" and we will assume such. Third, for households which owned their homes in both 1983 and 1986, we will assume that they are "non first-time homeowners" although this may be erroneous in some cases.

Table 1

Household Incomes
Average value for:

	Potential First-Time Homebuyers (ages 25-34)	First-Time, Homeowners (ages 25-34)	Non First-Time Homeowners (ages 25-34)	Non First-Time Homeowners (all ages)
1985 Incomes	$22,288	$34,321	$36,184	$102,315
1984 Incomes	18,922	27,038	31,242	95,690
1983 Incomes	16,357	23,166	27,900	83,855
Percent of households earning 1985 income:				
Less than $10,000	15.0%	4.2%	3.2%	11.6%
$10,000 - 19,999	31.6	15.1	12.2	16.3
$20,000 - 29,999	25.7	26.9	23.9	15.6
$30,000 - 39,999	18.2	18.5	28.4	13.4
$40,000 - 49,999	5.9	16.8	14.4	10.4
$50,000 +	3.7	18.5	18.0	32.7

Source: 1986 Survey of Consumer Finances, Federal Reserve Board.

Table 2

1986 Financial and Real Assets

Percent of households holding assets in 1986:

	Prospective First-Time Homebuyers	First-Time Homeowners	Non First-Time Homeowners	Non First-Time Homeowners (all ages & incomes)
Stocks and Mutual Funds	30.0%	20.8%	19.1%	34.4%
Bonds	21.0	30.2	33.5	33.6
Checking and Savings Accounts	100.0	97.9	98.9	96.4
IRA's and Keoghs	25.0	30.2	30.3	42.0
Money Market Accts and CD's	25.0	24.0	26.1	42.9
Profit Sharing and Thrift Accts.	31.0	29.2	31.0	20.1
Life Insurance, Cash Value	25.0	34.4	43.1	47.8
Other Financial Assets	1.0	2.1	4.3	12.3
Real Estate, other than Primary Residence	12.0	13.5	19.1	35.2
Business Assets	6.0	12.5	18.1	25.1
Vehicles	91.0	99.0	100.0	93.9

Source: 1986 Survey of Consumer Finances, Federal Reserve Board.

Table 3 1986 Financial and Real Assets

	Median 1986 dollar values* for:			
	Prospective First-Time Homebuyers	First-Time Homeowners	Non First-Time Homeowners	Non First-Time Homeowners (all ages & incomes)
Stocks and Mutual Funds	$1,100	$2,300	$2,000	$28,719
Bonds	150	500	500	7,600
Checking and Savings Accts.	1,950	2,000	2,250	4,000
IRA and Keogh Accts.	4,500	3,500	3,000	12,000
Money Market Accounts and CD's	5,000	3,100	7,000	21,000
Profit Sharing and Thrift Accounts	4,000	1,950	3,000	15,000
Life Insurance, Cash Value	1,862	2,345	3,500	5,091
Other Financial Assets	2,000	16,900	7,500	80,000
Real Estate, other than Primary Residence	25,533	30,000	29,000	100,000
Business Assets	1,114	4,221	19,332	105,000
Vehicles	6,000	7,702	7,315	8,420
Total Assets**	15,319	18,396	24,364	54,010

* Median values are based only on the households holding these assets. Because such a small percentage of households hold certain assets, the median values are sometimes based on a very small number of households.

** This does not include the current value of primary residences, whose inclusion would substantially increase the total value of assets of the homeowners.

Source: 1986 Survey of Consumer Finances, Federal Reserve Board.

Table 4

Reasons for Saving of
"Prospective First-Time Homebuyers"

Percent of households indicating as:

	First reason	Second reason	Third reason
To buy own house	32.0%	10.0%	1.0%
Emergencies, "rainy days," other unexpected needs; for security	20.0	10.0	8.0
For retirement/old age	8.0	9.0	1.0
To get ahead; for the future; to advance standard of living	8.0	1.0	4.0
To buy durable household goods, appliances, home furnishings; hobby items; other purchases	8.0	5.0	4.0
Investment reasons, e.g. to receive interest, to diversify, to invest	5.0	4.0	2.0
To travel/take vacations	4.0	7.0	2.0
Reserves in case of unemployment	0.0	4.0	1.0
To help kids out; for the family; to have children/baby	3.0	4.0	2.0
For children's (grandchildren's) education	2.0	5.0	1.0
Inappropriate (second and third reasons only)	0.0	28.0	69.0
Don't/can't save (first reason only)	1.0	0.0	0.0
Other	9.0	13.0	5.0

Source: 1986 Survey of Consumer Finances, Federal Reserve Board.

U.S. ECONOMIC OUTLOOK

APRIL 1989

	QUARTERS								YEARS				
	ACTUAL		FORECAST						ACTUAL			FORECAST	
	88.3	88.4	89.1	89.2	89.3	89.4	90.1	90.2	1986	1987	1988	1989	1990
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4909	5000	5108	5187	5263	5337	5422	5497	4240	4527	4864	5224	5537
% Change	7.3	7.6	8.9	6.4	6.0	5.7	6.6	5.6	5.6	6.8	7.5	7.4	6.0
% Change (w/out inflation)	2.5	2.4	5.0	2.5	2.0	1.9	2.0	1.5	2.8	3.4	3.9	3.0	1.9
Consumer Price Inflation (CPI)	4.8	4.4	5.3	5.0	4.6	4.6	5.2	5.1	1.9	3.7	4.1	4.9	4.9
GNP Inflation (GNP Deflator)	4.7	5.3	3.6	3.8	3.8	3.8	4.5	4.0	2.7	3.3	3.4	4.2	4.1
Unemployment Rate - Civilian	5.5	5.3	5.3	5.3	5.2	5.2	5.2	5.4	7.0	6.2	5.5	5.2	5.4
Civilian Employment-Household Basis (millions)	115.2	115.8	116.9	117.5	118.0	118.4	118.8	119.0	109.6	112.4	115.0	117.7	119.2
Percent change	2.0	2.2	3.9	1.8	1.7	1.5	1.2	0.8	2.3	2.6	2.3	2.4	1.2
Index of Industrial Production	138.4	139.9	141.2	142.3	142.8	143.4	144.0	144.3	125.1	129.8	137.2	142.4	144.5
Manufacturing Capacity Utilization	84.0	84.4	84.8	85.3	85.2	84.9	84.9	84.8	79.7	81.0	83.6	85.1	84.5
Domestic Auto Sales	7.6	7.5	7.0	7.2	7.2	7.2	7.2	7.2	8.2	7.1	7.5	7.2	7.2
Federal Tax Receipts (NIPA) as % of GNP	19.9	19.8	20.0	20.3	20.4	20.4	20.9	20.8	19.5	20.2	20.0	20.3	20.8
Federal Expenditures (NIPA) as % of GNP	22.4	23.0	23.0	22.9	22.9	22.9	23.0	23.0	24.4	23.7	23.0	22.9	23.1
Deficit(NIPA)	-123.5	-157.8	-151.4	-132.6	-131.1	-129.6	-118.3	-122.3	-205.6	-157.8	-142.4	-136.2	-124.3
as % of GNP	-2.5	-3.2	-3.0	-2.6	-2.5	-2.4	-2.2	-2.2	-4.9	-3.5	-2.9	-2.6	-2.2
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4692	4874	4607	4578	4638	4529	4349	4441	4712	4648	4651	4588	4386
Percent change -- year ago	3.6	9.6	-2.0	-2.0	-1.1	-7.1	-5.6	-3.0	10.8	-1.4	0.1	-1.3	-4.4
Existing Single-family Home Sales (thousands)	3663	3770	3510	3540	3590	3490	3305	3410	3565	3526	3594	3533	3347
Percent change -- year ago	6.8	11.2	6.4	-2.8	-2.0	-7.4	-5.8	-3.7	10.9	-1.1	1.9	-1.7	-5.3
Housing Starts (thousands)	1467	1559	1560	1477	1492	1476	1486	1471	1812	1634	1496	1501	1481
Percent change -- year ago	-9.4	1.7	5.6	-0.2	1.7	-5.3	-4.7	-0.4	4.1	-9.8	-8.5	0.4	-1.3
Single-Family Units	1061	1138	1131	1070	1081	1072	1076	1062	1183	1157	1089	1088	1071
Percent change -- year ago	-8.1	4.5	3.2	0.8	1.9	-5.9	-4.9	-0.7	10.4	-2.2	-5.8	-0.1	-1.6
Multi-Family Units	406	420	428	407	412	404	410	409	630	477	406	413	410
2-4 Family Units	57	65	67	63	64	63	64	64	85	66	59	64	64
Percent change -- year ago	3.0	16.0	16.1	10.4	12.2	-3.8	-4.3	0.3	-9.0	-22.6	-10.3	8.7	-0.7
5+ Family Units	349	355	362	344	348	342	346	345	545	412	347	349	346
Percent change -- year ago	-14.7	-8.2	11.7	-4.7	-0.4	-3.8	-4.3	0.3	-5.6	-24.4	-15.7	0.4	-0.7
New Single-family Home Sales (thousands)	703	682	670	680	690	605	570	585	750	671	677	663	585
Percent change -- year ago	4.1	9.8	7.6	-2.4	-1.8	-11.3	-15.9	-14.0	9.0	-10.5	0.9	-2.0	-11.8
Mobile Homes Shipped (thousands)	218	223	240	238	245	243	244	241	246	233	217	241	244
HOME PRICES													
Existing Home Prices - Median $(1000)	90.2	88.7	92.1	93.8	95.1	95.6	96.7	98.1	80.3	85.6	89.3	94.1	99.1
Percent change -- year ago	5.5	4.4	4.9	5.5	5.4	7.8	5.0	4.6	6.4	6.6	4.3	5.4	5.3
New Home Prices - Median $(1000)	114.9	114.9	115.3	117.5	119.0	120.2	120.9	123.4	92.0	104.0	112.5	118.0	124.1
Percent change -- year ago	8.2	2.8	2.1	4.0	3.6	4.6	4.9	5.0	9.1	12.9	8.2	4.9	5.2
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year FRM (FHA Secondary)	10.7	10.6	10.9	11.2	11.1	10.8	10.7	10.6	9.9	10.2	10.5	11.0	10.6
1-year ARM (without buydown)	8.3	8.5	8.8	9.1	8.9	8.7	8.6	8.5	9.5	8.5	8.5	8.9	8.5
Corporate AAA Bond Rate	10.0	9.5	9.7	10.2	10.0	9.9	9.7	9.7	9.0	9.4	9.7	10.0	9.9
Government Bond Rate	9.2	9.0	9.0	9.4	9.3	9.1	9.0	9.0	7.8	8.6	9.0	9.2	9.0
Short-Term Interest Rates													
Federal Funds Rate	8.0	8.5	9.5	10.0	9.8	9.5	9.0	8.8	6.8	6.7	7.6	9.7	8.8
3-month T-Bill Rate	7.0	7.7	8.4	9.3	9.1	8.7	8.4	8.1	6.0	5.8	6.7	8.9	8.1
Prime Rate	9.7	10.2	10.9	11.8	11.6	11.2	10.8	10.4	8.3	8.2	9.3	11.4	10.4
Discount Rate	6.3	6.5	6.7	7.0	7.1	7.1	7.0	6.8	6.3	5.7	6.2	7.0	6.8
Value of the U.S. Dollar (Trade-Weighted Avg.)	97.6	93.0	96.3	96.4	92.5	89.5	87.7	85.7	112.3	96.9	92.8	93.7	86.3
Percent change	35.6	-17.6	15.1	0.7	-15.5	-12.0	-8.1	-8.7	-21.6	-13.6	-4.3	1.0	-7.9

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr Frederick Flick, Sean Burns and Beth Maerz.

EQUAL HOUSING OPPORTUNITY